The Forex Trader's Guide to Price Action

Over the past few months, we've published multiple articles on the topic of Price Action, which is the study of one of the most pure indicators available to traders: Price.

With knowledge of price action, traders can perform a wide range of technical analysis functions without the necessity of any indicators. Perhaps more importantly, price action can assist traders with the management of risk; whether that management is setting up good risk-reward ratios on potential setups, or effectively managing positions after the trade is opened.

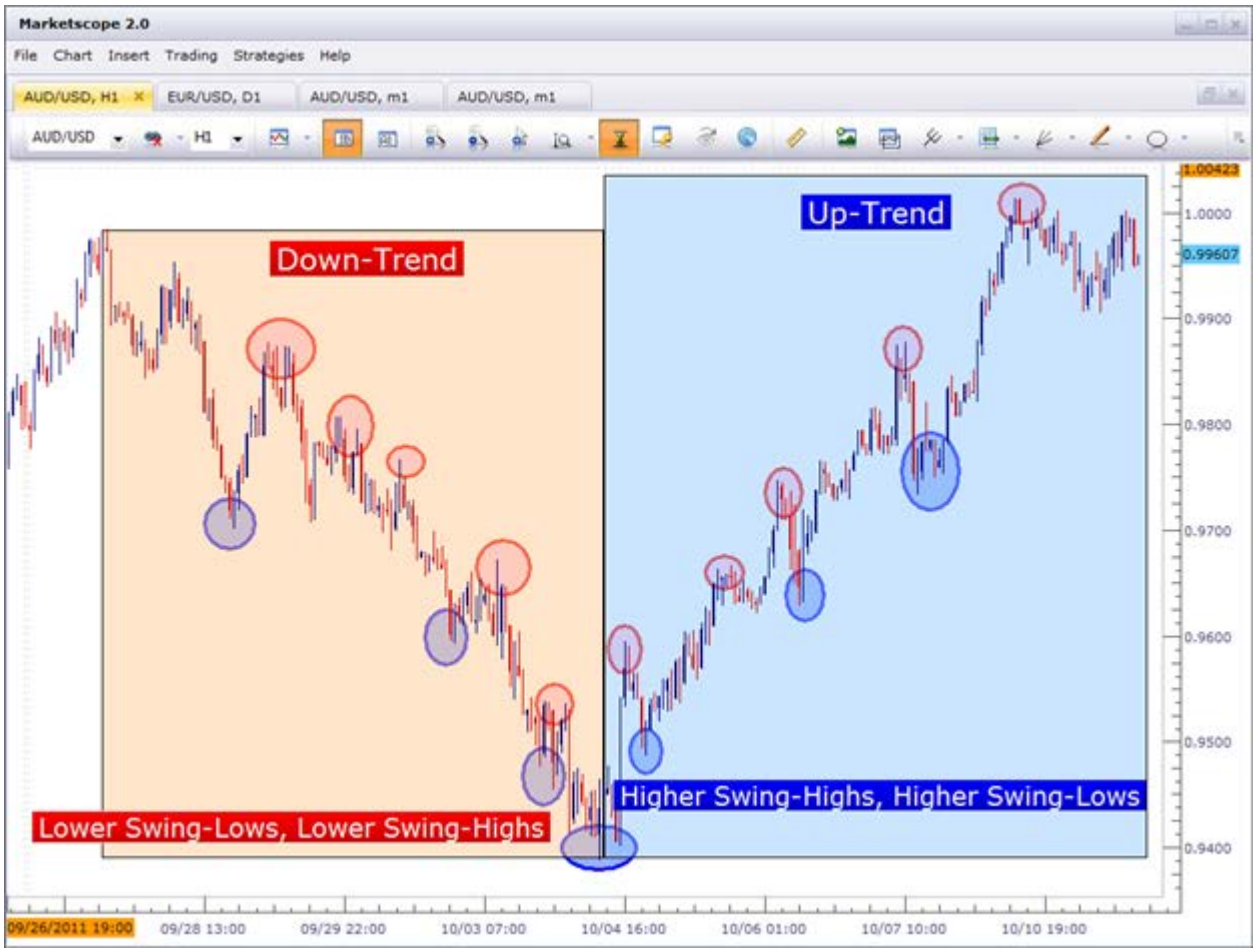
This article is a capstone of all of price action studies that we've published thus far; teaching traders to analyze and grade trends, enter trades in 6 different ways with various setups, and manage risk while looking at support and/or resistance.

Before we get into the individual elements of price action, there are a few important points to establish.

Trend Analysis

The first area of analysis that traders will often want to focus on is diagnosing the trend (or lack thereof), to see where any perceivable biases may exist or how sentiment is playing out at the time.

In Price Action Introduction we looked at how traders can notice higher-highs and higher-lows in currency pairs to denote up-trends; or lower-lows, and lower-highs to qualify down-trends. The chart below will illustrate in more detail:



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VISIT…

Entering Trades

After the trend has been analyzed, and the Price Action trader has an idea for sentiment on the chart, and trend in the currency pair – it's time to look for trades.

There are quite a few different ways of doing so, and we've published quite a few resources on the topic.

In Price Action Pin Bars, we examined one of the more popular candlestick setups available, which traders will commonly call a 'Pin Bar.' The Pin Bar is highlighted by the elongated wick that 'sticks out' from price action. The picture below will show a pin bar in greater detail:

Pin Bar Setup
Candle Wick 'Sticks Out' from Price Action
Wick is more than 2 times the size of the candle body
Trader enters long looking for reversal
No Recent Price Action at these Levels

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We took this a step further in How to Trade Fake Pin Bars, as we looked at how traders can trade candles that show long wicks that don't quite 'stick out' from price action. This is where trend analysis can greatly assist in the setting of initial risk (stops and limits). The following picture will show how a trader might want to play a 'Fake Pin Bar.'

Fake Pin Bar in Direction of Trend
Trader goes short after fake pin bar forms
Stop placed just outside the top of wick
Currency pair is trending down
making lower lows and lower highs

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Periods of congestion or consolidation can also be used by traders utilizing price action. In Trading Double-Spikes, we looked at the 'double bottom' or 'double top' formation that is popular across markets. We looked at two different ways of playing Double-Spikes, both of which we've outlined in the following 2 charts.

We looked at the Double-Spike breakout for instances in which traders are anticipating that the support (or resistance) that has twice rebuked price may get broken with strength. The Double-Spike breakout is plotted below:

Double-Spike Breakout
Continuation Move
Looking for a furtherance of previous trend
Entry Order Placed Below Support
If Price breaks support and continues to trend, entry order will trigger trade

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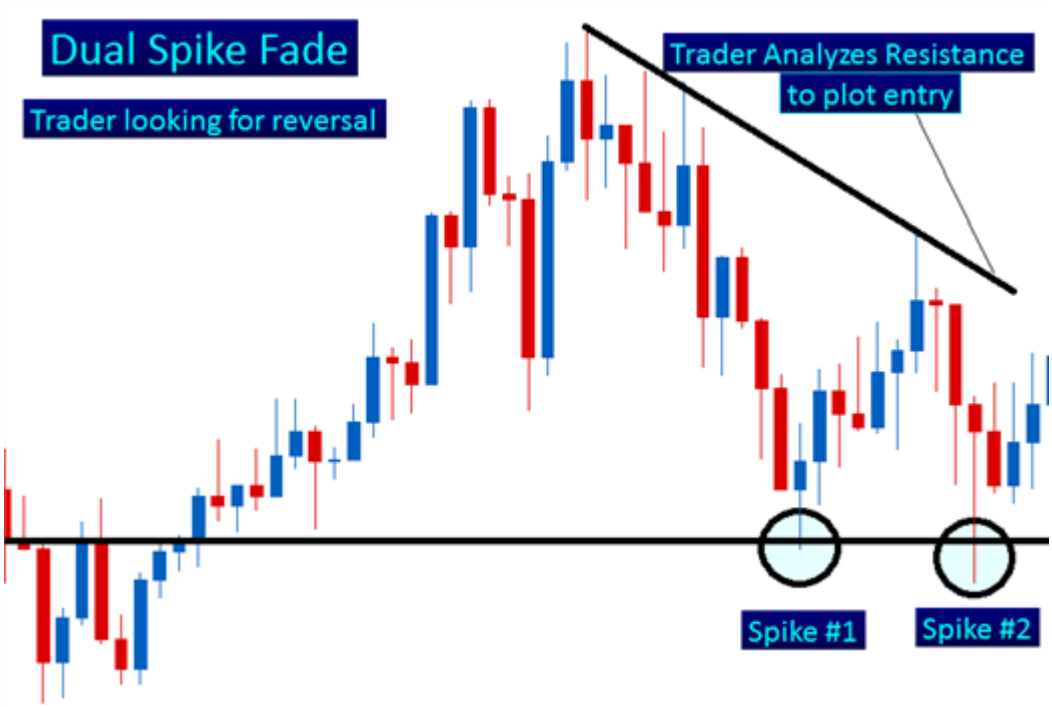
And for situations in which traders are anticipating support or resistance continuing to be respected, the Double-Spike Fade may be more accommodating:



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On the topic of congestion, another very popular setup that we discussed was Trading Price Action Triangles.

While there are different types of triangles, most traders look to trade these periods by anticipating a breakout. Below is the 'Descending Triangle,' in which price has respected a horizontal support level while offering a down-ward sloping trend-line. Related is the ascending triangle that is highlighted with an upward sloping trend-line. In both instances, traders are often looking to play breakouts of the horizontal support or resistance level (this horizontal line is support for descending triangles, and resistance for ascending triangles).

Descending Triangle
Lower-Highs, with Strong Horizontal Support
The Tightening Range can lead traders to wait for price to Breakout

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If no horizontal support or resistance exists, traders may be looking at a 'symmetrical triangle,' which adds an element of complication since there are no horizontal levels with which to look to play breakouts. The following illustration shows a symmetrical triangle setup, along with how a trader may look to trade it:

When price breaks upper or lower bounds of Symmetrical Triangle
Trader enters market in that direction
Looking for price to continue in that direction

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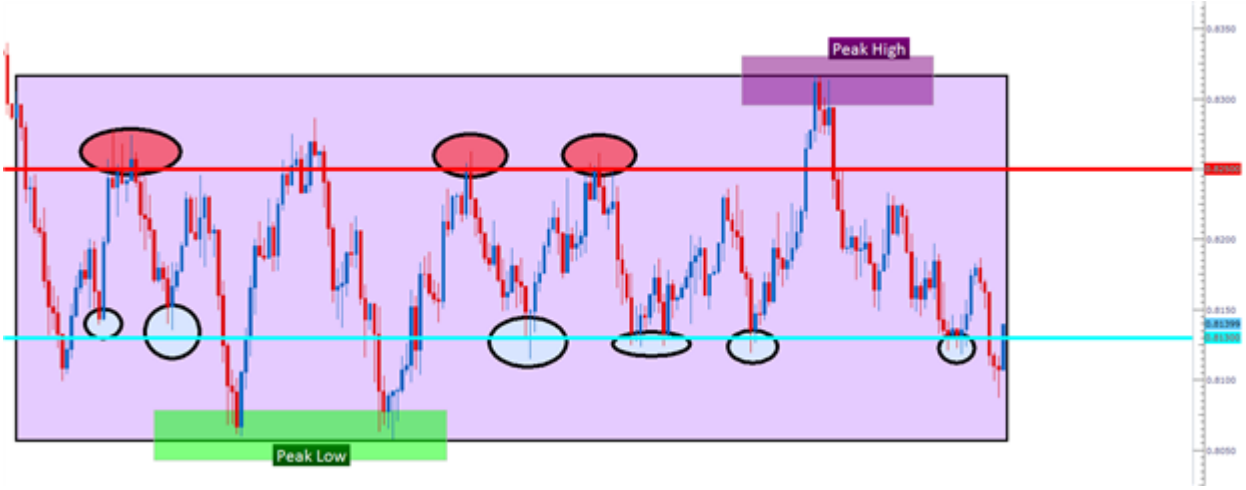
And for periods in which the market is ranging the article How to Analyze and Trade Ranges with Price Action went over the topic in detail.



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Risk Management

In Price Action Swings we identified 'swing-highs' and 'swing-lows' with which traders could use to identify comfortable areas of setting stops or limits.

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And of course, in an up-trend:

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We took this a step further in the article [How to Identify Positive Risk-Reward Ratios with Price Action], so that traders can analyze the relevant swings to decide whether or not the potential trade (given its management parameters) would be warranted.

Potential Reward
Potential Risk
Swing low established
Trader looks to set stop just below swing low
Trader can look to take profits at previous swing-high

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And of course, once we are in the trade, managing profits is a topic of key consideration. We looked at exactly that in [Trading Trends by Trailing Stops with Price Swings]. The following picture will illustrate this concept further:

Initial Stop Placed
As position moves further lower, trader moves stop lower
When trend reverses (and new highs are made)
Trader is stopped out

Price Action, an Introduction

Technical Analysis is the process of using the price chart itself to assist in trading decisions. While this may sound initially confusing, please let me explain.

The price chart, reflecting all changes that have happened to price within a specified period, can be looked at another way; the price chart can also be considered a gauge of trader's sentiment during that same specified period.

As news came out that was bullish for the asset, the market prices that news accordingly to reflect a higher price. If news came out that was bearish, the exact opposite can be true, the chart will reflect losses to account for the incorporation of this new information.

Future events, which have not yet taken place, are unknown and as such, are not yet currently reflected in price.

The Technical Analyst operates under the presumption that the chart, at any point in time, reflects the sentiment of all known information in regards to that asset at that specific moment in time.

If the trader tries to read the price chart directly, it can often prove confusing. Price movements can, often-times, appear erratic and chaotic with little rhyme or reason. Below is a weekly chart of the EUR/USD currency pair. This chart, which contains an uptrend, a downtrend as well as an element of 'congestion,' could prove difficult for a trader to analyze.

This is where indicators can help.

Indicators, based on past price information, can be added in an effort to assist the trader in making heads or tails of what is actually going on. The list of possible indicators to be used can go on for quite awhile, and there are a lot of different mannerisms in which indicators can come into play. But there is one universal concept that many Technical Analysts try to keep in mind:

No indicators or Trading Systems works 100% of the time.

Once again, we have to remember that price action, like any other future event, is unpredictable – especially when we're using past price information to make those decisions.

This is where price action can help.

Price action is the process of using the price chart itself, without any indicators, to assist in trading decisions.

To get started, lets first look at one of the more pertinent areas of analysis: Trend identification.

Many traders, with the idea that future prices are unpredictable, simply try to use Technical Analysis to try to 'get the odds on their side.'

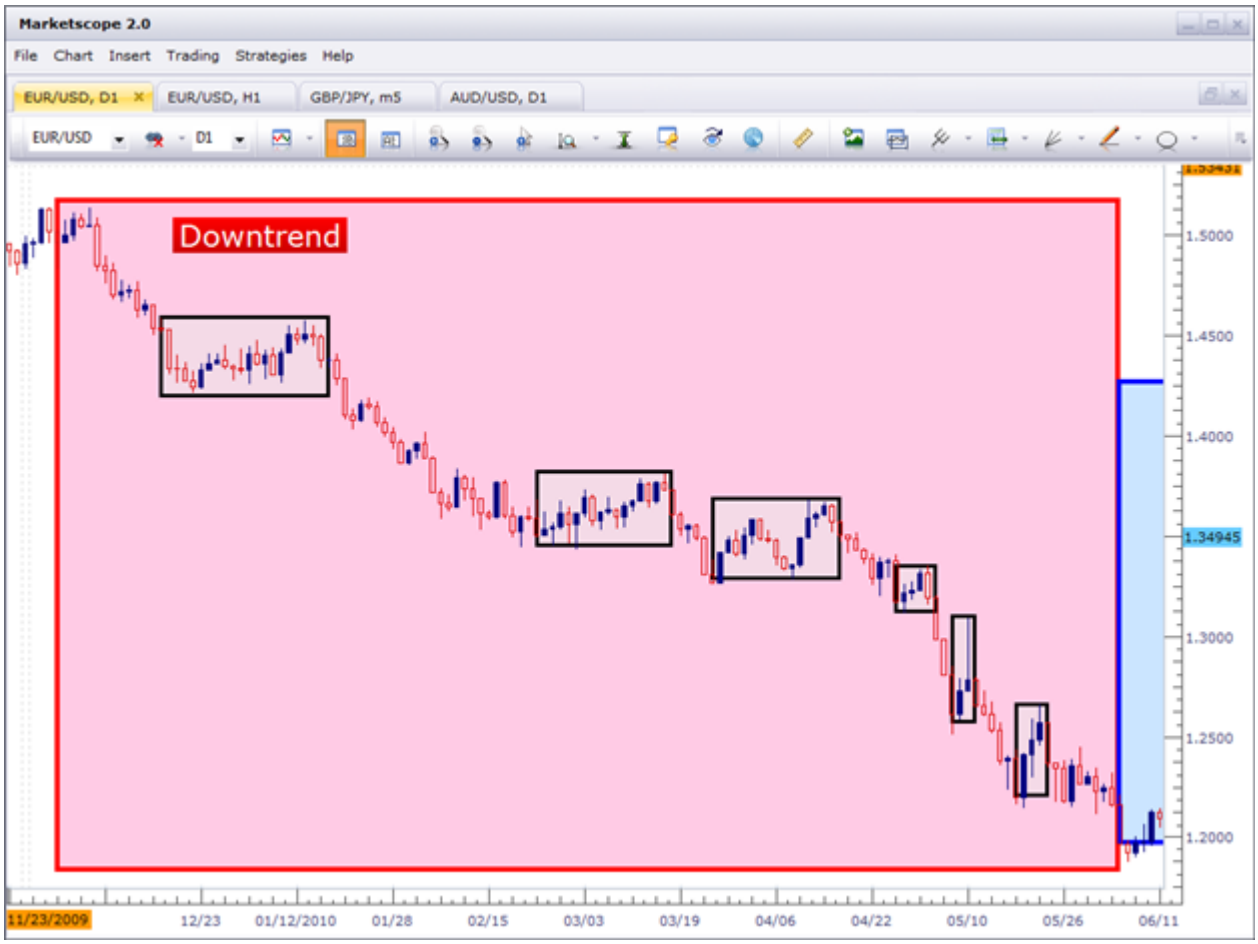
Traders can attempt to identify their trend under the presumption that price, of recent, had shown a bias in one direction and that bias may, perhaps, continue. If price is in a down-trend, then traders can look to initiate short positions in an attempt to be on the correct side of this bias in price. If price is showing an up-trend, the exact opposite can be true; where traders are looking to Buy into long positions so that this bias may work for them to push their trades higher.

Below is the same chart we had looked at previously, a weekly EUR/USD chart, but this time we have 2 sections identified.

No indicators were needed to identify these trends; this was done entirely from the chart itself.

Notice that during the down-trend, price did not make a linear movement down in a straight line. Most of the movement can be explained by big moves down, followed by congested price action, followed by further moves down.

Below is the same chart, but this time we've went down to a Daily time-frame.

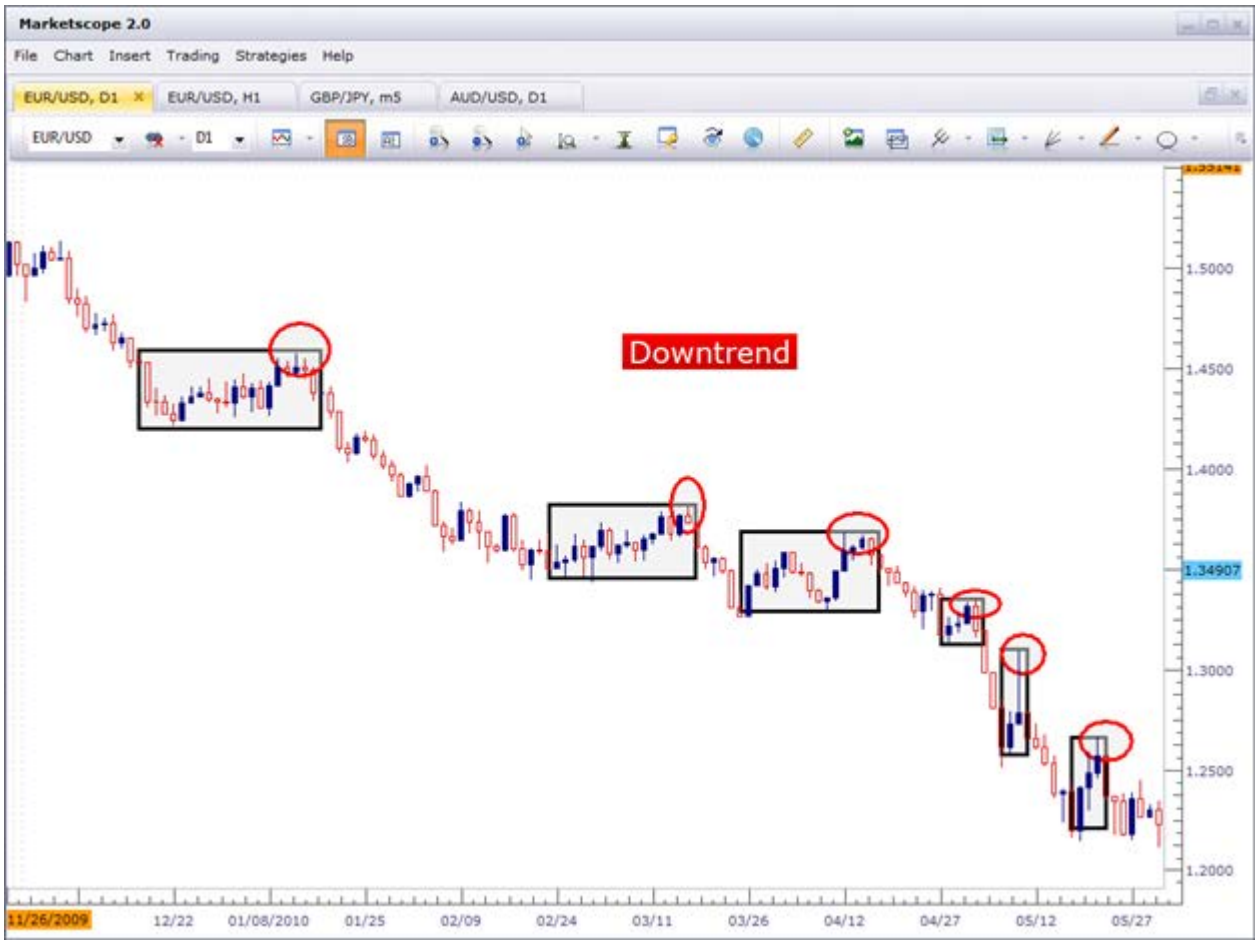


Each dark box identifies the periods of ‘congestion,’ during the downtrend.

As the trend began above 1.50, notice the quick movements made as the currency pair trends down. Shortly after piercing 1.45, a run of ~500 pips, the currency pair begins to display congestion; exhibiting price movements that disagree with the direction of the trend.

But these ‘counter-trend,’ price movements don’t last for long, as the currency pair, eventually, strives to even lower levels.

During these periods of ‘congestion,’ or ‘counter-trend,’ price movements, the trader can notice the rice swings displayed on the price chart. Below is our EUR/USD chart with swing-high’s circled in red.



Did you notice something that was consistent amongst each of these 'swings?'

Each swing-high is at a lower price than the previous swing.

Lower-lows and lower-highs are being exhibited on the chart. And with this, I can then grade this as a 'down-trend.'

Marketscope 2.0
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EUR/USD, H1
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AUD/USD, D1
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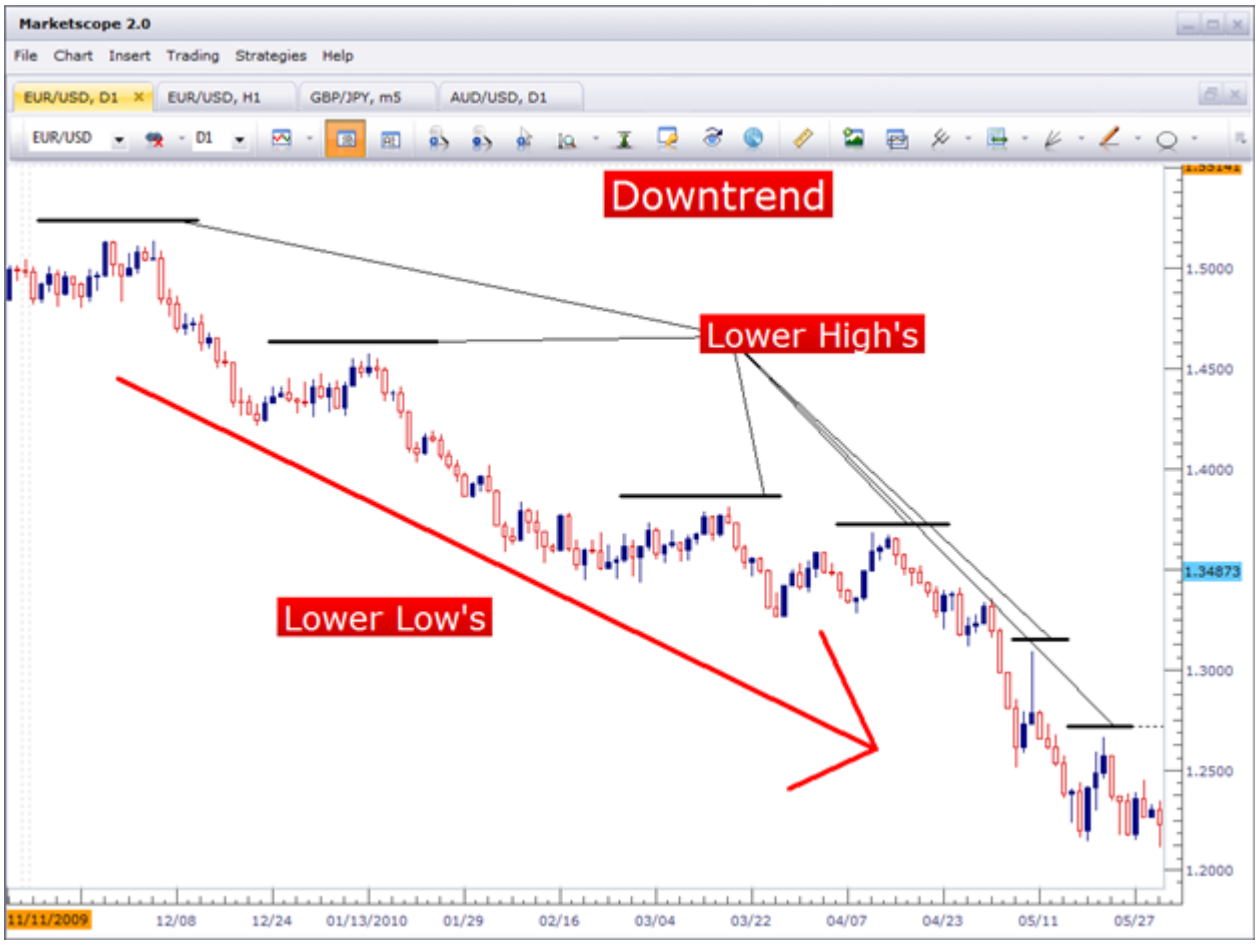


The exact opposite can hold true for Uptrends.

Over our next few price action articles, we'll take a look at mechanisms that can be used to potentially trigger into trades in the direction of the trend.

Price Action Pin Bars

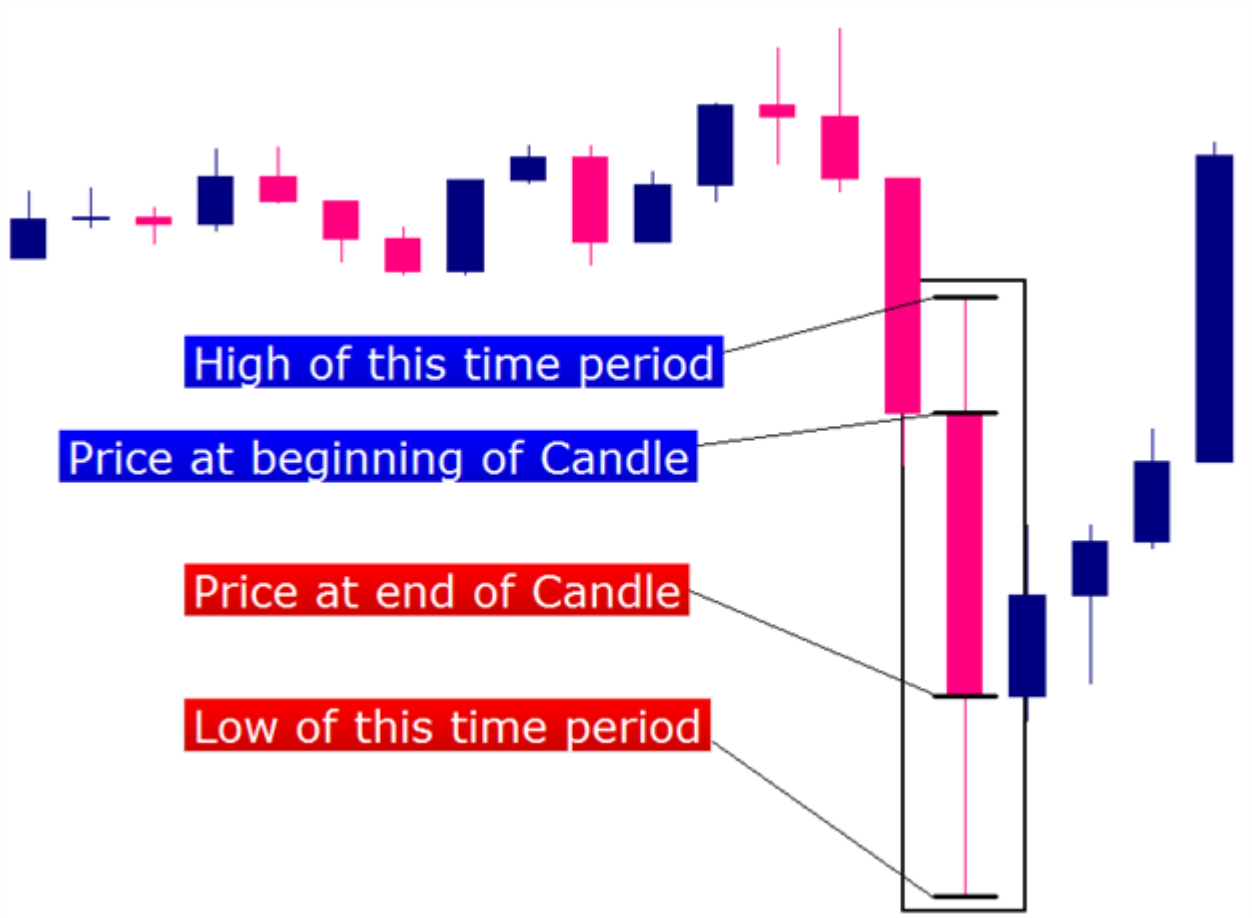
As we discussed in our last article in regards to price action, traders can potentially use the price chart itself, devoid of any indicators to make trading decisions.

There are numerous price action mechanisms that traders use in attempt to get the odds on their side as well as possible.

One of the more desired conditions that traders can look for are short-term reversals in price. Candlesticks themselves can help us see some of these potential reversals, with the Pin Bar.

Pin bars, which are short for 'Pinocchio,' bars, attempt to find candle wicks that 'stick out,' from price action in an effort to capitalize on particularly volatile market conditions.

To get deeper in a pin bar, lets first examine candles and candle wicks in closer detail with the picture below.



(Created with Trading Station 2.0/Marketscope)

In the candle displayed above, drawn inside the rectangle, notice that this would be a decline in price as the currency pair closed at a lower value than it had opened. The difference between the open and close is often referred to as the 'candle body.' The skinny area above and below the candle body are commonly referred to as 'wicks.'

Also notice that price actually proved quite volatile during this period, and this can be seen from the 'wicks,' of the candles. Although this candle shows price moving lower from the open to the close, the wicks can show the astute trader that price had actually climbed at one point! This can be seen from the wick atop the candle.

As price was moving higher than the candle open at the time, this would have appeared as a 'bullish,' candle. But that was a temporary movement as negative momentum came back in the pair only to push price lower; much lower in fact. So low that price actually began increasing, exhibiting that the pair may have been oversold.

When the candle completes, we have a long wick that 'sticks out,' from price action. This is the pin bar:

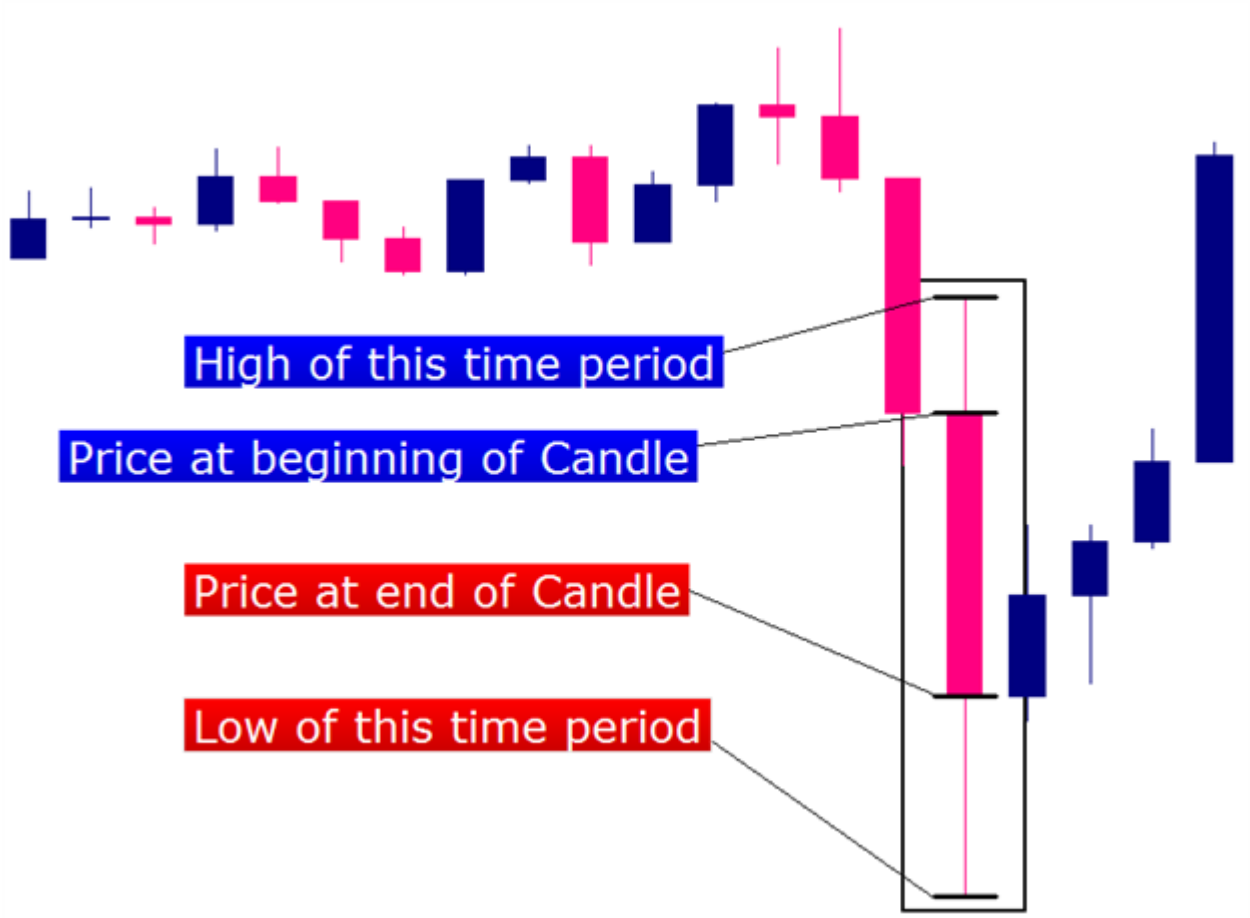
(Created with Trading Station 2.0/Marketscope)

When the trader notices the pin bar, they can imagine the price action that had driven price higher may potentially continue into the next candle.

Traders can potentially look to go long in the above setup, looking to play on the strength that had driven price off the low values in the pin bar.

Now, it is important to keep in mind that not all Pin Bars can be identified as 'tradeable,' opportunities. By nature, trading on pin bars are 'counter,' to current price action exhibited.

In the below setup, please take a look at what is happening leading up to the pin bar that forms:



(Created with Trading Station 2.0/Marketscope)

Before the pin bar forms, price has made a fast move to the downside, which some traders may construe as a downtrend. Opening a long position would be going in exactly the opposite direction, which could potentially prove costly.

With Pin Bars, its important to add other areas of price action or technical analysis to further confirm the entry into the trade. This is where trading in the direction of the trend, or trading with Support and Resistance can come in handy. Luckily for the price action trader, much of this can be identified directly off the chart without the need of any additional indicators or strategies!

How to Trade Fake Pin Bars

One of the more compelling entry triggers via price action is the Pin Bar.

Pin Bar, which is short for 'Pinocchio Bar,' is a single candlestick setup that clues price action traders into potential reversals in the market. A pin bar is an elongated wick that 'sticks out' from price action. Traders will usually look for one-sided wicks that are two times the size of the candlesticks body.

When traders see elongated wicks sticking out from price action, they can look for the momentum that created the long wick to continue by looking for a reversal.

So if a trader sees a long wick sticking out below price action; they can look to go long. If a trader sees a long wick sticking out above price action, they may want to look to go short.

Pin Bar Setup
Candle Wick 'Sticks Out' from Price Action
Wick is more than 2 times the size of the candle body
Trader enters long looking for reversal
No Recent Price Action at these Levels

Created with Marketscope/Trading Station

Much like Pinocchio's nose – the elongated wick of a pin bar can tell us that a lie is being told.

But not all long wicks are created equal. As a matter of fact, many of these long wicks will not be Pin Bars at all; but that does not mean that they can't be used by Price Action traders. This article will walk through how to trade 'fake' Pin Bars, or long wicks that do not stick out from price action.

What separates a Pin Bar from a Fake Pin Bar?

The difference between a Pin Bar and a Fake Pin Bar is determined by recent price action.

If the long wick sticks out from recent prices, that is a Pin Bar. This is the 'lie' that the market may be telling us: That a movement to a previously untested level has brought a new group of buyers (or sellers in the case of a bearish Pin Bar).

If the long wick does not stick out from previous price action; they are not a genuine Pin Bar, but rather 'Fake Pin Bars.' The picture below will illustrate with further detail:

This is a Fake Pin Bar
The Wick is more than 2x the size of the body
But the Wick DOES NOT 'Stick Out' from Recent Price Action
Recent Price Action Nullifies this as a 'Pin Bar'

Created with Marketscope/Trading Station

As you can see above picture, the fake pin bar doesn't quite stick out from previous and recent price action.

With a genuine pin bar leaving a long wick above the candle, traders could look to open a short position to take part in the momentum that created the long wick in the first place.

However, as you can see from the above setup – that would not have worked out too well.

Trading Fake Pin Bars requires additional analysis, as the signal of a short-term reversal in prices may not be as consistent as that of a genuine pin bar.

How to Trade Fake Pin Bars

The first thing we want to get comfortable with when looking for Pin Bars, or Fake Pin Bars, is what it is that we are looking to take part in by trading that setup. Let's take a closer look at a legitimate Pin Bar below:

Pin Bar
After price made a strong run down
Traders bid the currency pair off its lows
This is what creates the long wick
Since this is outside price action, the move down may be extreme
But price pushing higher, exposing the wick
clues traders into potential reversals

Created with Marketscope/Trading Station

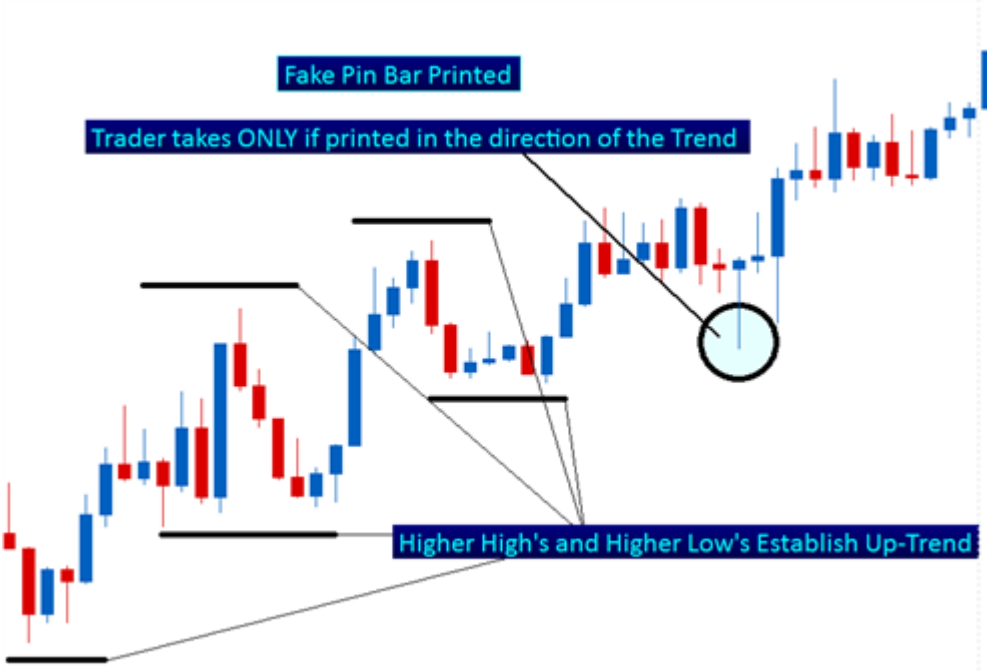
From the above graphic, we can see what makes the pin bar attractive is the fact that price has reversed enough to leave a long wick exposed underneath price action (all taking place during the pin bar candle).

But what if a long wick isn't sitting outside of recent price action?

This might mean that the potential for a reversal on fake pin bars could be smaller than that of genuine pin bars. But that doesn't mean that price action traders can't use this information to our advantage – we merely have to qualify which fake pin bars might be favorable and which are not.

We can do this by looking at the trend of the currency pair, and attempting to enter ONLY in the direction of the longer term trend. Traders can even use price action analysis to qualify and analyze trends, much like we looked at in our Introduction to Price Action.

To do this, we would want to scroll out on our charts and analyze more previous prices than if we are trading a genuine pin bar; and the reason for this is so that we can get a better assessment of the long-term trend and look to only trade in that direction. The picture below will illustrate an up-trend with a bullish fake pin bar.


Fake Pin Bar Printed
Trader takes ONLY if printed in the direction of the Trend
Higher High's and Higher Low's Establish Up-Trend

Created with Marketscope/Trading Station

From the above graphic, we can see that after price had established an up-trend by creating a series of higher highs, and higher lows a fast price movement to the downside was corrected before the candle had completed (leaving the long wick circled above).

Traders can look to trade this fake pin bar by going long after this candle has formed, placing a stop slightly below the low of the fake pin bar wick. That way, if price happens to reverse against us (and move down while we are in a long position), we can exit the position if a lower price is printed below the bottom of the fake pin bar wick (picture illustrating further is below):

Fake Pin Bar in Direction of Trend
Trader goes short after fake pin bar forms
Stop placed just outside the top of wick
Currency pair is trending down
making lower lows and lower highs

Trading Double-Spikes (Price Action)

One of the greatest parts about trading price action is that traders can see sentiment playing out on the chart with one of the most pure indicators available: Price.

Double-bottoms and double-tops can be appealing setups for traders as the market has shown a willingness to react to a specific price. The picture below will show an example of a double bottom. Notice that after an elongated down-trend the currency pair bounces from the same price on two separate occasions.

Created with Marketscope/Trading Station

This clues the trader in to the fact that something is going on at this price. Unfortunately it won't tell us what exactly, and whether or not we should buy or sell – but it does tell us that this is an important price in the currency pair.

The reasons for the bounce could be endless. Perhaps there is a large corporation looking to exchange currency setting a line in the sand with which they want to buy. Or perhaps this price is a strong level of support (much like Parity on USDCAD or AUDUSD).

Whatever the reason may be, we can use the information that we do know to strategize a manner of entry into the trade; but first we have to decide which direction we want to make a play.

Double Spike Breakout

The Double Spike Breakout looks to play a continuation move in the currency pair, expecting the support (or resistance) that has reversed price in the past to become broken on another attempt. The picture below will illustrate in more detail:

Double-Spike Breakout
Continuation Move
Looking for a furtherance of previous trend
Entry Order Placed Below Support
If Price breaks support and continues to trend, entry order will trigger trade

Created with Marketscope/Trading Station

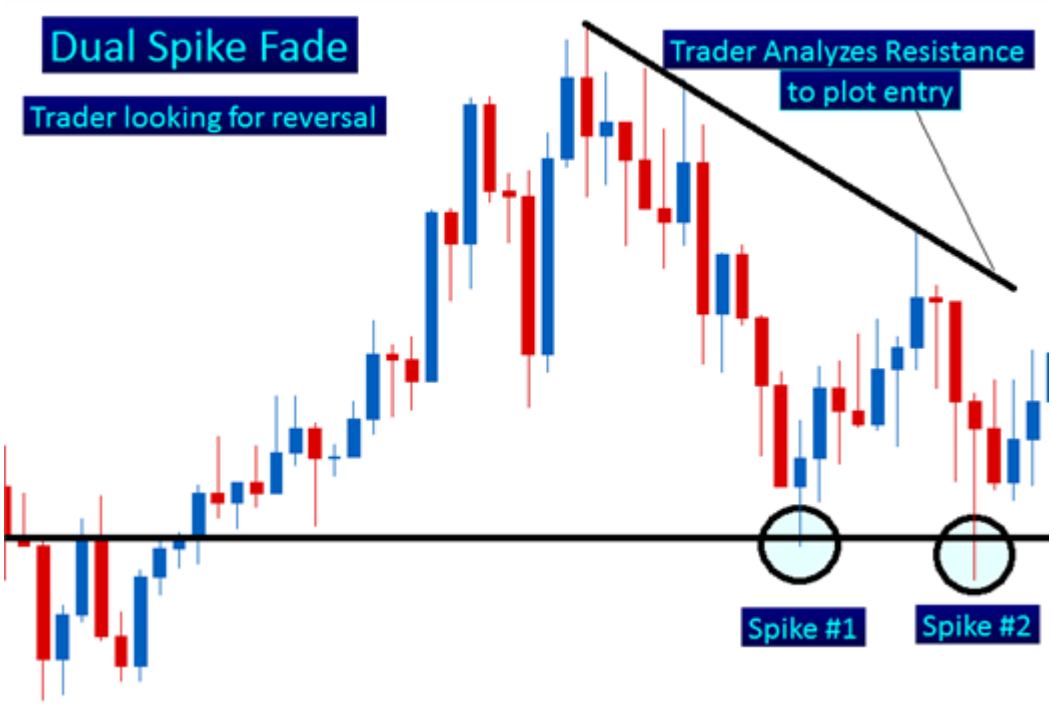
With the Double-Spike Breakout, it's important to remember that, like any breakout, price can easily reverse against us and move for an extended amount of time.

Given that price has bounced twice in the past, it is perfectly reasonable to expect that price may break support enough to enter our position, and then reverse against us. So prudent rules of money management when trading breakouts apply; and risk-reward ratios may be more favorable at 2:1 or greater (looking for 2 dollars of profit (or more) for every 1 dollar risked).

Double-Spike Fade

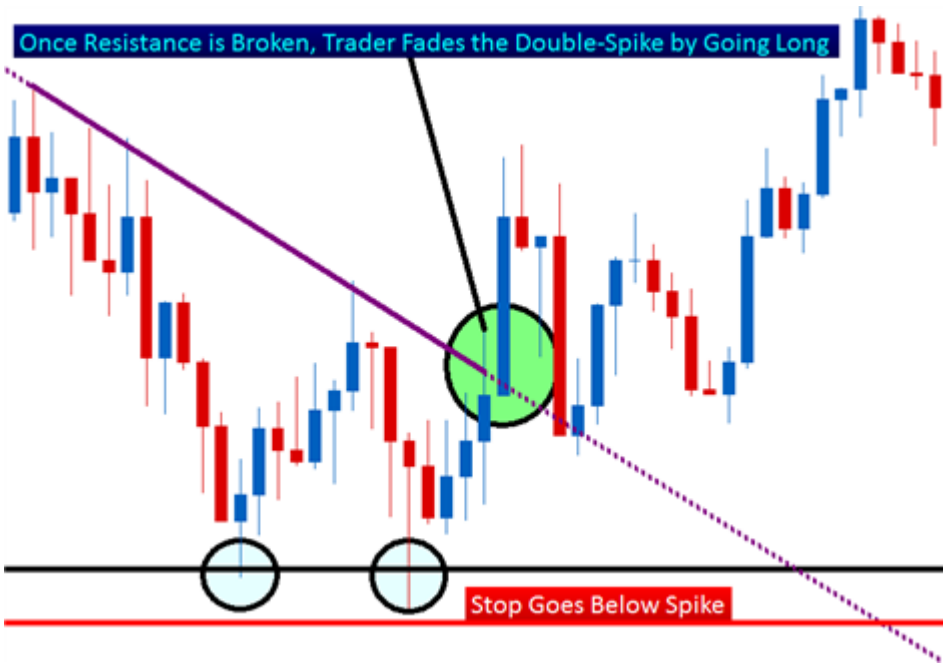
The Double-Spike Fade is the opposite of the earlier strategy in the fact that it looks for a reversal after seeing the second bounce off of support (or resistance). However, since the trader doesn't have the luxury of substantiated support and/or resistance – a different modal of entry is necessary.

The chart below will show a bearish market buckling off of support offering a dual-spike with which the trader can look to fade:



Created with Marketscope/Trading Station

Once resistance is broken, the trader can look to open the position. In this example, since we were looking to 'fade' the move that created the double-spike (and since the move was bearish leading price to support) the trader would be looking to buy this currency pair. The picture below will illustrate further:



Trading Price Action – Triangles

Trading in ranging or congested periods in the market can prove challenging for a number of reasons; and because of this many traders choose to wait for prices to breakout before looking to initiate a position.

This article will walk through one of the more common congestion patterns in use by price action traders: The Triangle; as well as possible ways that traders can look to play this pattern.

What is a triangle?

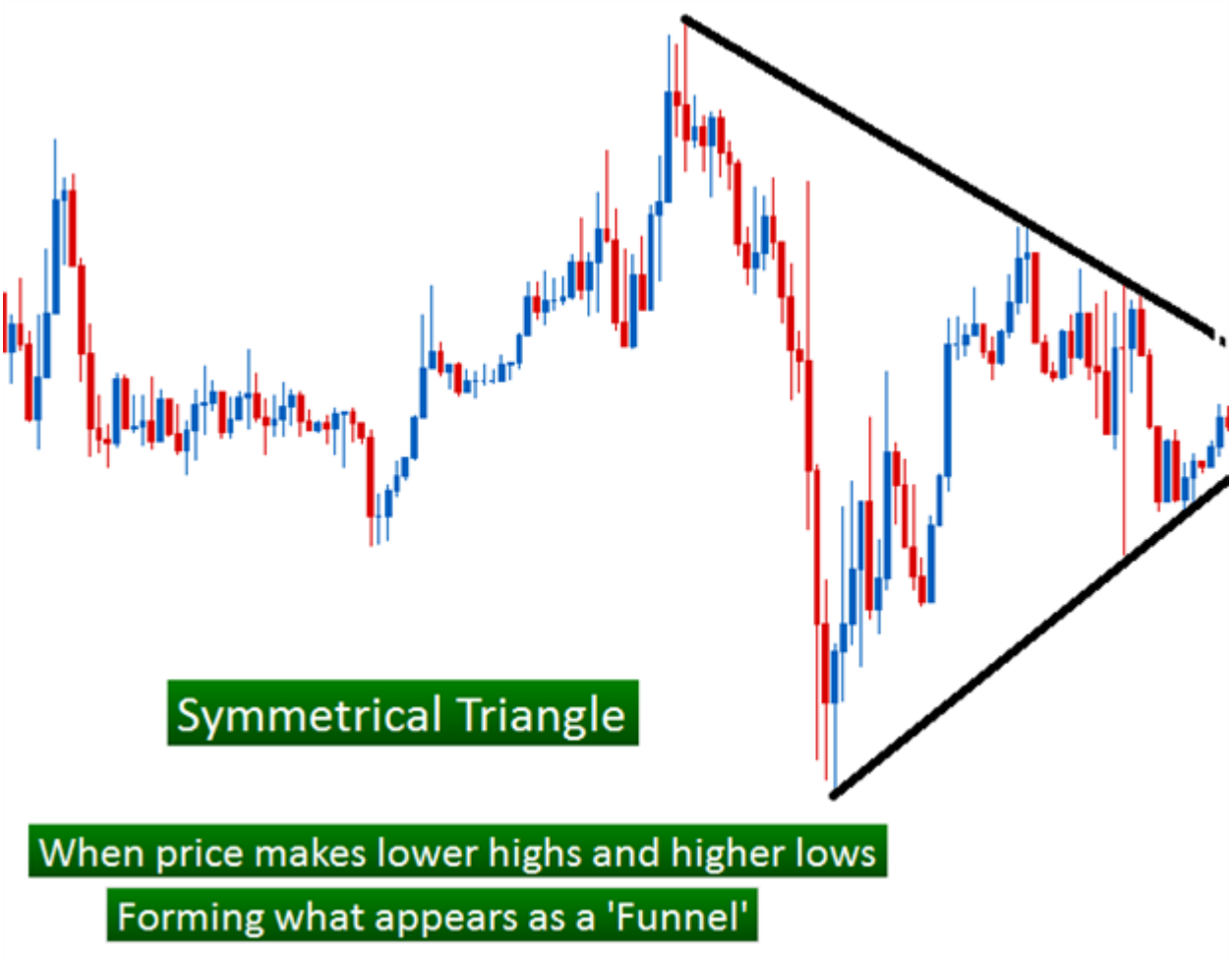
A triangle is a period of activity in which prices form what literally appears to be a triangle, or wedge on the chart. The below picture will illustrate a 'descending triangle:'

Descending Triangle
Lower-Highs, with Strong Horizontal Support
The Tightening Range can lead traders to wait for price to Breakout

Created with Marketscope/Trading Station

As you can see, the currency pair is in the process of making lower highs and lower lows; but it has not yet been able to decisively break through previously established support.

This tightening range of prices can offer a potential setup to the price action trader. Before we get into how to plot trades on triangles, let's take a look at another flavor of the triangle formation.



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How to trade Ascending / Descending triangles

The most common way of playing triangles is to look for breakouts as either support or resistance is being broken. With the Ascending or Descending Triangle the trader has luxury of a strong element of support and/or resistance to utilize. Let's take a look at the same descending triangle we looked at a moment ago:

Descending Triangle
Lower-Highs, with Strong Horizontal Support
The Tightening Range can lead traders to wait for price to Breakout

Created with Marketscope/Trading Station

As the currency pair is making lower highs while buckling up to a strong support line, traders can get the idea that the weakness in the pair isn't quite great enough to break through, but at some point, may be able to. And if price momentum is strong enough to break through support, price may be able to continue to run.

So many traders will go into a Descending triangle as we see above with a bearish stance, looking to enter the trade once support can become broken. This can be done by placing an entry order to go short below support.

For Ascending Triangles, the trader can look to a bullish bias as higher lows have been unable to break through resistance. The trader can look to enter by placing an entry order to go long above resistance.

Symmetrical Triangles are a little different as a strong element of static support and/or resistance isn't available in the same way as it might be with an ascending or descending triangle.

With a symettrical triangle, because price action is narrowing by making both higher lows and lower highs, traders might be unsure of which direction a possible breakout may occur.

As such, it may be more prudent to wait until the break of support or resistance takes place; and then looking to trade the pair in that direction.

When price breaks upper or lower bounds of Symmetrical Triangle
Trader enters market in that direction
Looking for price to continue in that direction

How to Analyze and Trade Ranges with Price Action

The benefits of strong trends can be obvious. Strong trends are one of the many reasons that record-numbers of traders are flocking to the FX Market from other arenas such as stocks, or equity options. When a currency pair like the Australian Dollar goes on a run as it did through 2010 and the first half of 2011, the benefits to traders can be huge. Not only can a massive number of pips be racked up, but in a positive carry trade – traders can also earn rollover just for holding the position.

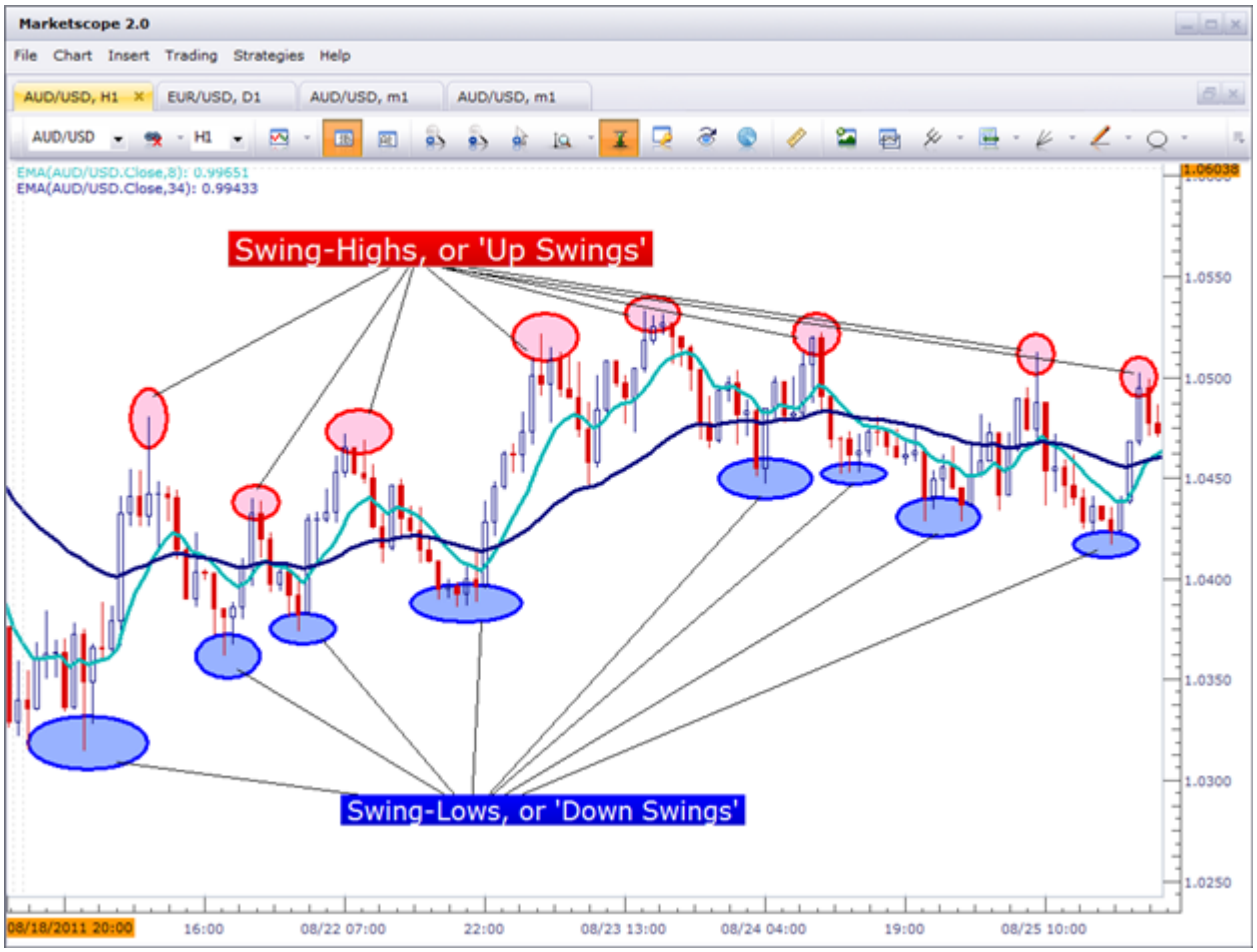
But it is an unfortunate truth that markets will not trend forever. Sometimes this amounts to a little congestion in the middle of an up (or down) trend; others this may be extended congestion while the market struggles to find a defined direction.

This article will walk through a simple mechanism by which traders can identify, and trade in ranges while focusing on what many traders to be the most important part of any approach: Risk management.

Identifying Support and Resistance via Price Action

In Price Action Swings, we looked at a way that traders can identify inflection points in the market based on where price had traded before. The benefits behind this can be huge.

While past prices will never predict what will happen next on the chart with 100% accuracy, they can help us define our approach, and our stance in the market. The following picture will show an assortment of swing highs and lows identified on an hourly chart:



Created with Marketscope/Trading Station

Notice that, on this hourly chart, there are quite a few swings back and forth. This exemplifies the fact that markets will often oscillate while trying to find an *intrinsic value.*

When beginning to line up a range setup, the number of swings that might be available on the hourly chart may be too abundant. The longer time-frame charts, however, can offer quite a bit of information contained in each candle so that we can get more of a 'birds-eye view' on the market. So for this portion of analysis, the Daily chart may work better. Below is a current example on the NZDUSD currency pair, using the Daily chart:

Created with Marketscope/Trading Station

Right off the bat, we can notice that price, of recent, has been caught within a range. The purple box below will show the period that I am referring to:

Created with Marketscope/Trading Station

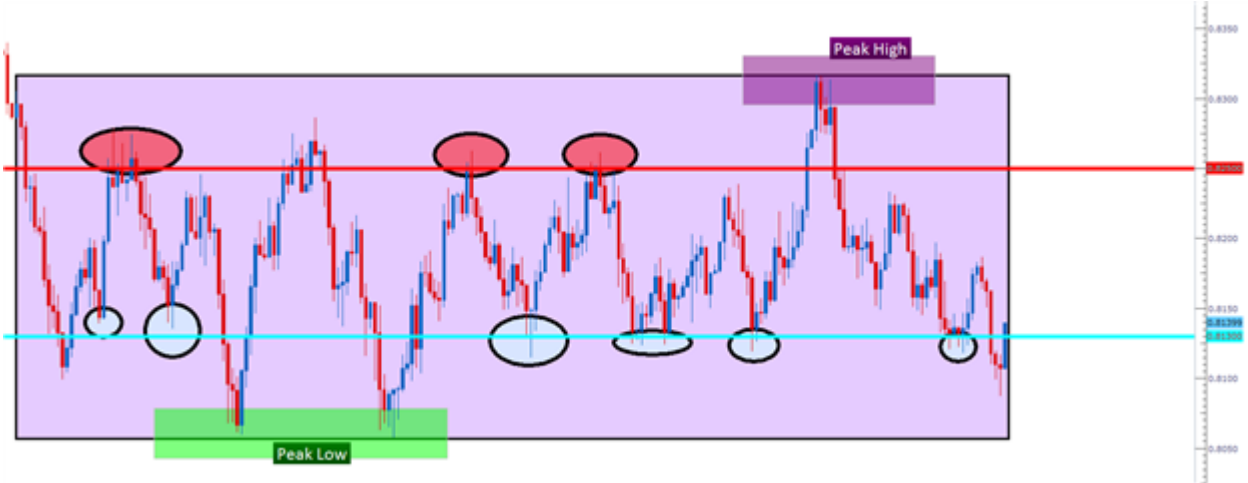
Notice that since March the 5th(approximately 7 weeks before the publishing of this article), all prices in this currency pair have stayed within the box; with a low price of .8057 and a high of .8321 (a total of 260 pips from top to bottom).

After we've established the range and the absolute high and low point of the prices during that period – we can move on to the next step of further defining support and resistance within the box. This can be done on a shorter time-frame chart such as the 4 hour. This will allow us to take a closer look inside the range to plot possible buy and sell points.

After moving down to the 4 hour chart, we can look for groupings of swing lows around specific prices. This can often develop around 'psychological whole numbers' such as .8100 or .8300 (any number ending in 000 can be looked at as a 'round' number – or even 100 pip increments). The chart below will show the 4 hour setup of the same chart we were seeing above, with swing lows identified.

Created with Marketscope/Trading Station

As you can see above, there are multiple inflections within the box we had previously identified that will allow us to further identify support and resistance. While this chart has a lot of information on it that is key to setting up a trade, we can simplify this quite a bit more (chart below):



Created with Marketscope/Trading Station

Notice that the prices we had identified collections of swing highs or lows previously is now identified on the chart, and is going to serve a very functional purpose in setting my game-plan for the currency pair.

We can illustrate that game-plan directly on the chart with what has already been given to us by the market. Since we have seen multiple iterations of price bouncing up at the price zone of .8130 for support; and multiple iterations for price driving lower after hitting the .8250 resistance zone (with no prices breaking above our peak high of .8321, or our peak low of .8057) – we can then line out the prices with which we want to buy, sell, and manage our risk. The chart below will illustrate:

Stops for SELL position go above Peak High
Look to Sell when price tests resistance
Look to buy when price tests support
Stops for BUY position goes below Peak Low

Created with Marketscope/Trading Station

Risk Management decides our Entries

Now that we've identified the prices at which we want to buy, the prices with which we want to sell, and maybe even more importantly than that – where we want to place our stops, we can now begin to decide when we want to enter the trade.

In The Number One Mistake that Forex Traders Make, we saw that are best served by seeking risk-to-reward ratios of 1-to-1 or higher. What this means, is that anytime I open a trade I want to ensure that my potential profit is AT LEAST as large as my potential loss (if the trade moves to my stop).

And now that we know exactly where our stops should be placed, we can accurately calculate how much potential risk we are taking on.

Let's walk through a real-world example. Let's assume that we enter a Long (buy) position at .8220 – which is slightly below the blue line in the above chart.

And remember, we want to place our stop just below the 'peak low' that was seen previously – at .8057. We can do the quick math (.8220 - .8057) to find that we are risking 63 pips on the trade.

For us to enter, we have to feel confident in being able to gain at least 63 pips.

We can even plot this on our chart (below):

Created with Marketscope/Trading Station

If I feel confident in being able to gain 63 pips in the above trade setup (as I would considering that recent prices have been in this neighborhood, and the most recent 'swing-high' was within this price range) – then I will place the trade.

If I do not feel confident in being able to gain at least 100% of my risk amount, (the 63 pips from my entry to the stop) I do not place the trade.

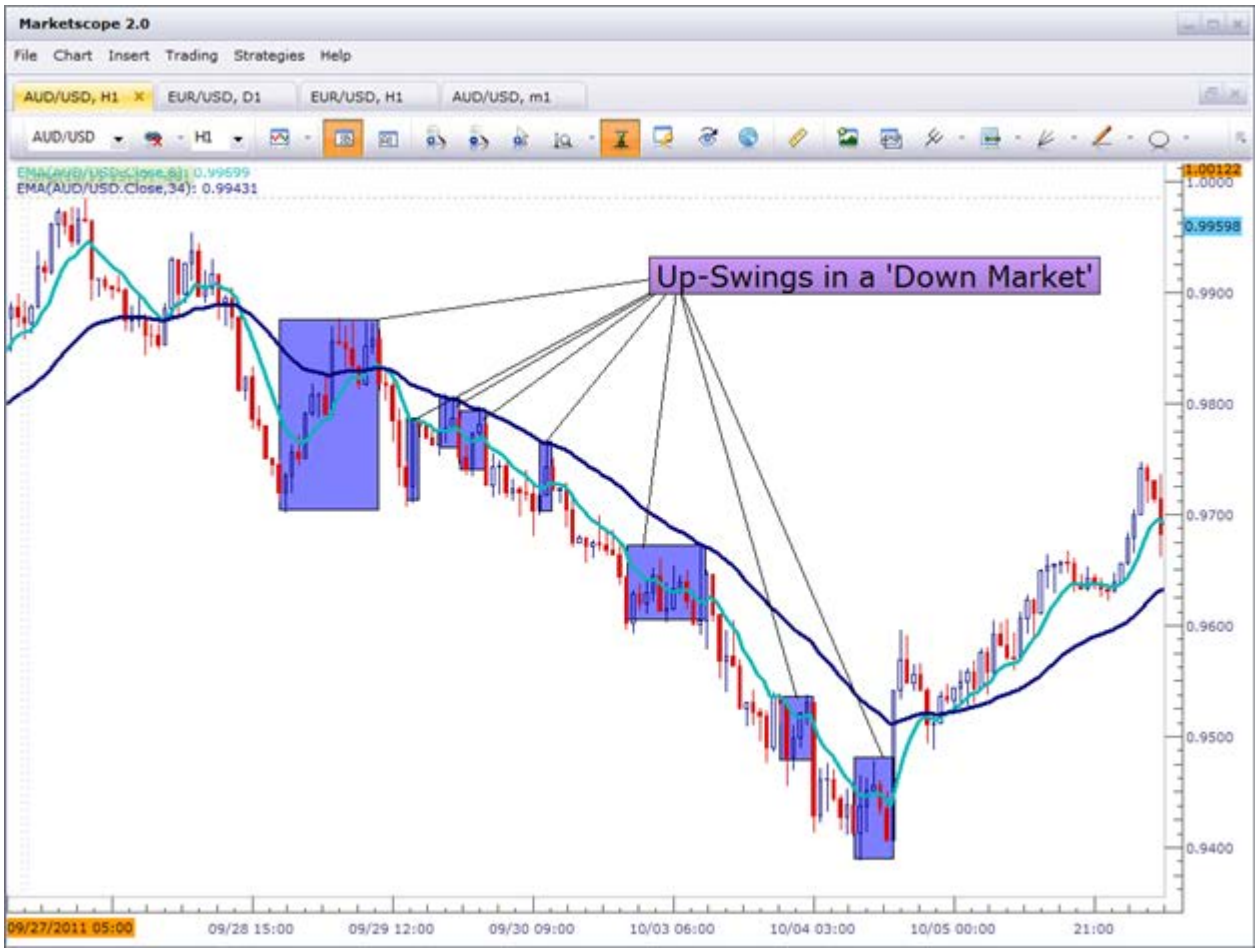
By allowing my potential risk-reward setup to determine which trades I am taking, and which I am not taking, I am enabling myself to focus on high-probability setups.

If price breaks lower, and takes out my stop – I can feel comfort in the fact that I may have saved myself a considerable amount of money as I closed the losing position before it continued to move against me and drain my account. If this happens, the range that I was looking to take part in is invalidated – and this speaks directly to the reason that we had first identified support and resistance on the longer-term Daily chart – looking to encompass the 'peak-highs' and 'peak-lows.'

Price Action Swings

Any chartist that has spent considerable time analyzing candlesticks would agree: Market movements rarely take place in a linear fashion.

Down-trends are often accented with 'up-swings,' as the chart below points out:

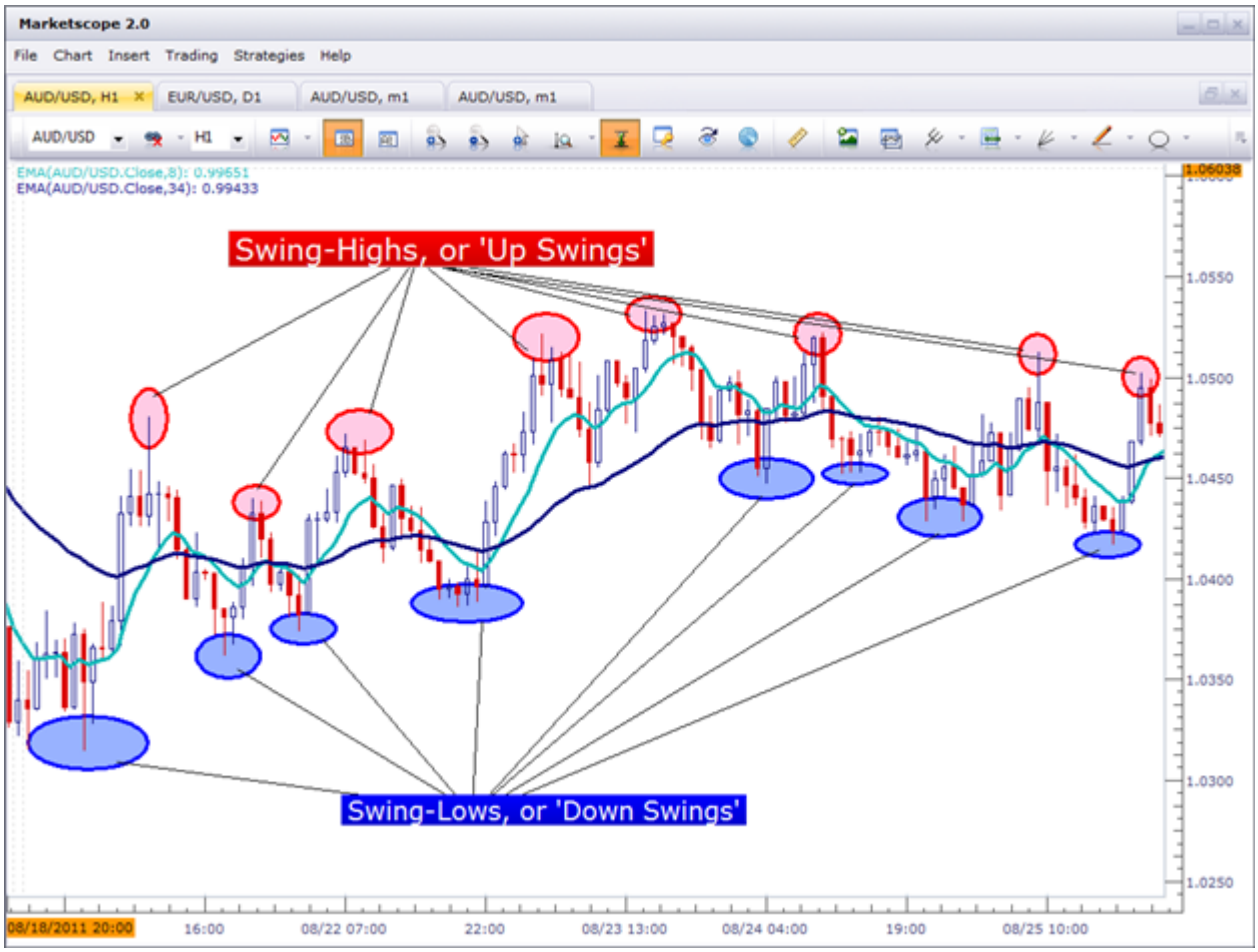


(Created with Trading Station 2.0/Marketscope)

The exact opposite can be said for up-trends, being accentuated with ‘down-swings.’

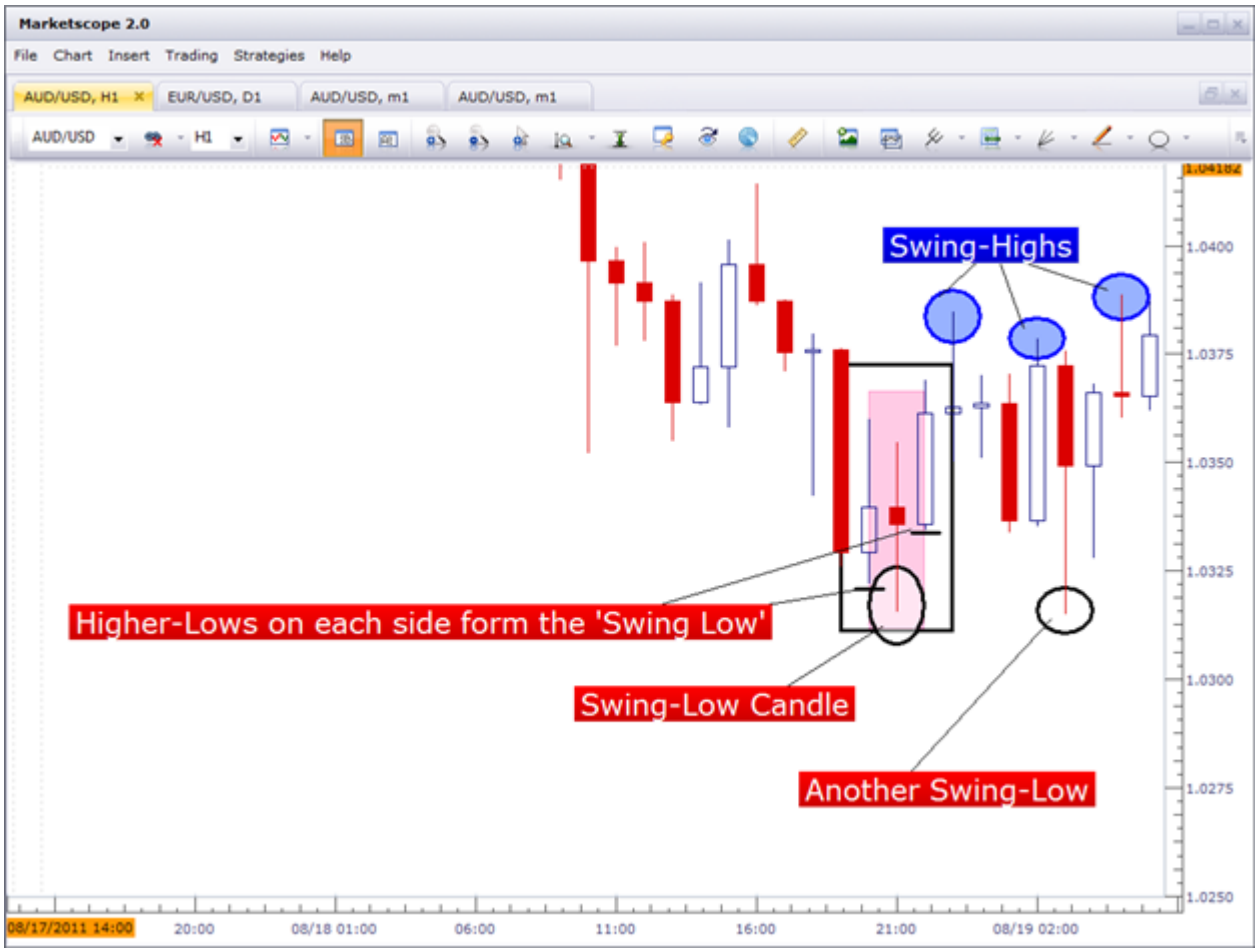
(Created with Trading Station 2.0/Marketscope)

And of course, if we have a range, we can notice both up-swings and down-swings.



(Created with Trading Station 2.0/Marketscope)

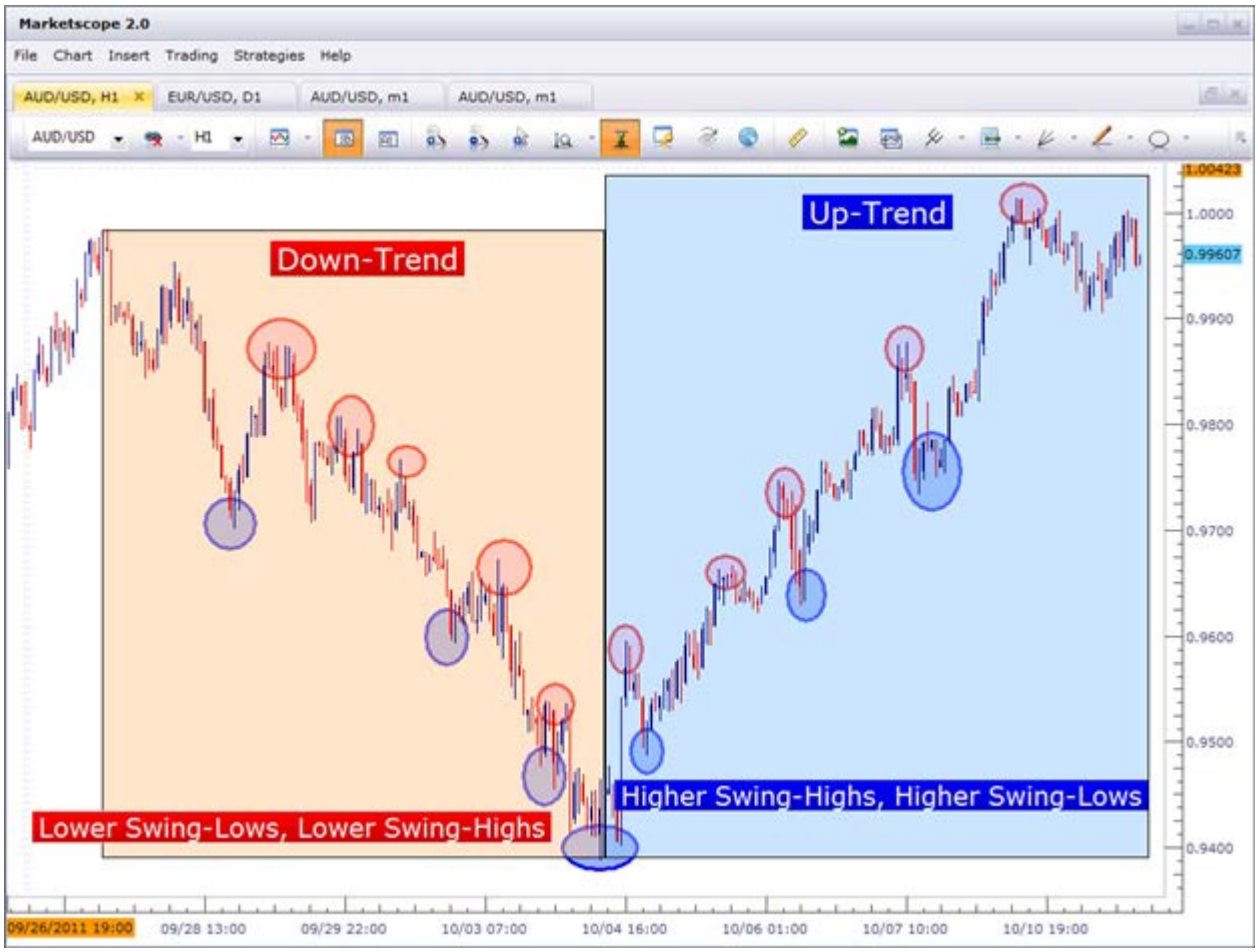
Swings-Lows, or Down Swings, can be classified as a low point of price that is accompanied by a 'higher-low,' value in price on each side of the candle.



(Created with Trading Station 2.0/Marketscope)

The multiple swings exhibited by price behavior throughout the day can be used for a multitude of functions.

For instance, for traders wishing to grade trend, they can often do so by observing ‘higher-highs, and higher-lows,’ or ‘lower-lows, and lower-highs.’



(Created with Trading Station 2.0/Marketscope)

Taken a step further, traders wishing to manage risk can potentially look to these swings for stop placement. For example, in the chart below, the trader looking to take on a long postion can adopt the stance:

“If price breaks this swing low, then I no longer want to be in my trade as the trend may no longer be to the upside.”

(Created with Trading Station 2.0/Marketscope)

And of course, once a trader is in a position – this same mindset can be used in position management. The chart below illustrates:

(Created with Trading Station 2.0/Marketscope)

We've covered 3 of the more popular mechanisms of 'Swings,' in the market, but we are just scratching the surface. There are numerous additional mannerisms in which these swings can be used by the price action trader.

How to Identify Positive Risk-Reward Ratios with Price Action

One of the most common mistakes made by traders; not just new traders but all traders, is the fact that they often win such smaller amounts when they are right than the losses they take when they are wrong.

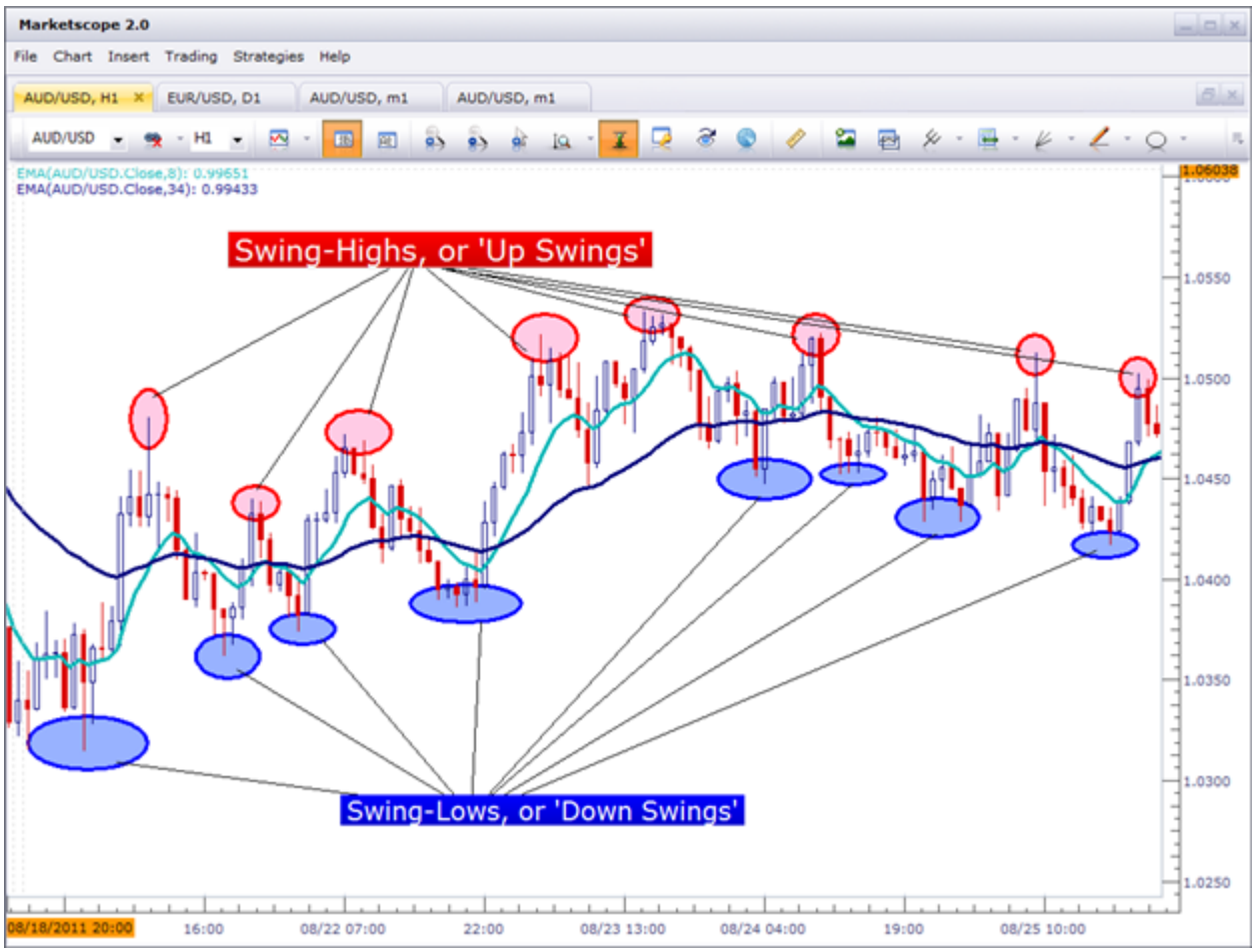
In the Number One Mistake that Forex Traders Make, DailyFX found that risk-to-reward ratios, also often called risk or money management, was often the most common pitfall for traders.

This article will teach traders to use one of the best indicators available, Price Action, to identify potentially advantageous risk-to-reward ratios, in which traders might be able to make far more on their wins when they are right than they lose on their losses when they are wrong.

This will allow those traders to focus on ONLY opportunities in which they feel they can profit more if they are right than they may lose if they are wrong.

Identifying Support and Resistance with Price Swings

In our Price Action Swings article we looked at ways that traders can look to recent price history to get a rough idea of where Support and Resistance may be most operative. The chart below will show a series of 'swing-highs' and 'swing-lows' identified:



Created with Marketscope/Trading Station

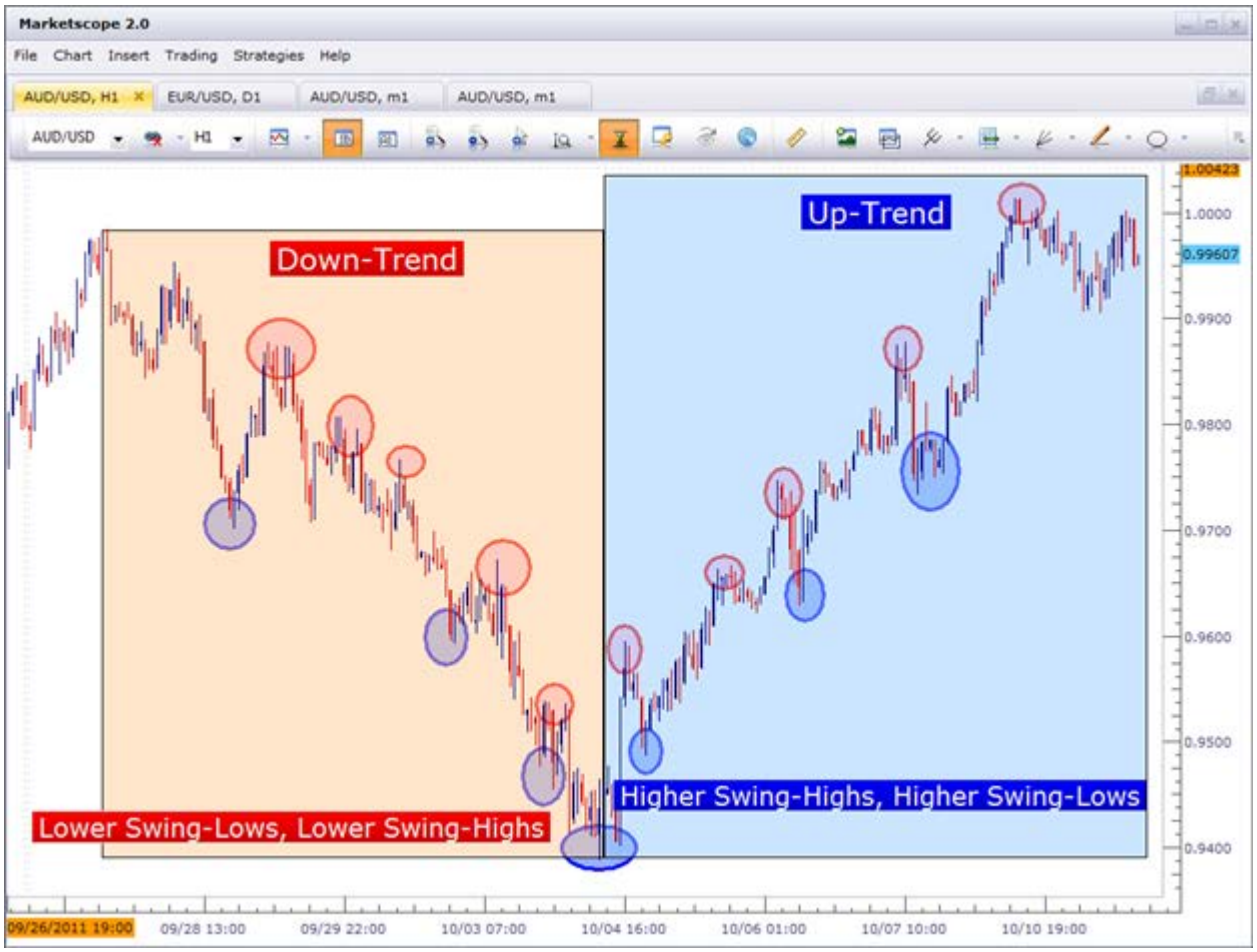
To identify a price swing, we simply want to notice the inflection of the candle at that specific period. As you see on the 'swing-lows' in the above chart the market had swung down, establishing a low point before moving higher.

The 'swing-highs' are the exact opposite. The market oscillated to make an inflection point higher on the chart before reversing and moving down.

We will never be able to predict when a future swing may happen – but we can use the swings that have already taken place to identify potential risk-to-reward ratios.

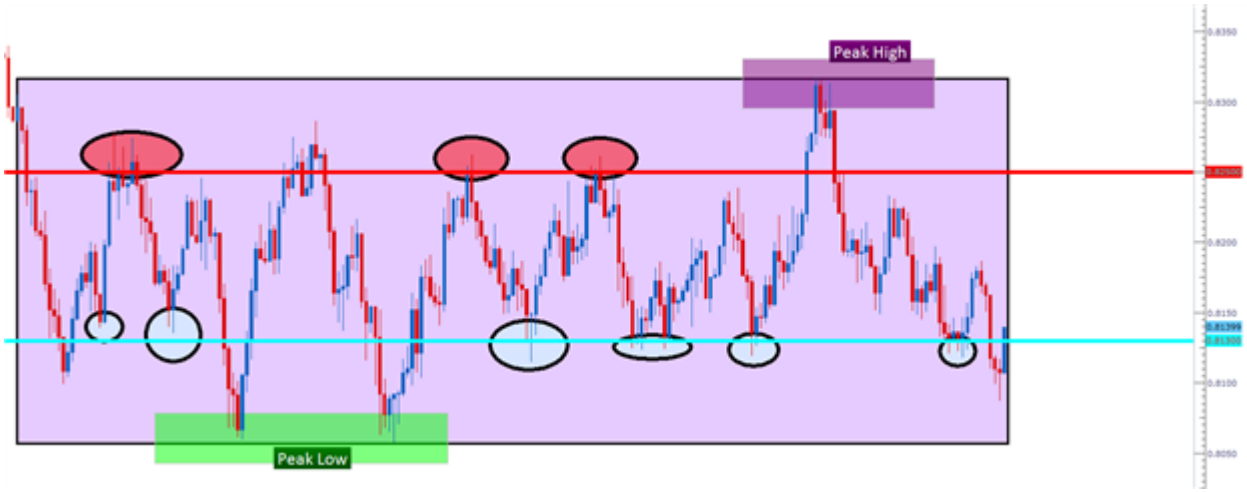
Identify the Market Condition

The role of price action can differ depending on the prevailing market condition. If the market is moving higher, price will often make a series of 'higher-highs' and 'higher-lows.' During down-trends, price will often make a series of 'lower-lows' and 'lower-highs.' The chart below will illustrate both an up, and down-trend:



Created with Marketscope/Trading Station

However, when the market offers no trend – price action may stay within a 'range' of prices; and these also can be used, albeit in a slightly different mannerism. The chart below will show price action swings in a ranging market:



Created with Marketscope/Trading Station

As you can see in the above chart, almost all of the prices printed on the chart stay within the purple-colored box.

After we've identified the market condition, we can then move on to lining up the potential risk-to-reward ratios on the trade.

Matching the Strategy to the Market Condition

Once a trader has analyzed the currency pair's market condition, they can then begin to setup their trade. An important note here – if the chart you are seeing is showing something unclear – you most certainly do not have to trade it. One of the beautiful parts of the currency market is that there are so many options that you can choose to trade.

If NZDUSD is showing you an unclear chart with a difficult-to-determine market condition, don't hesitate to flip over to AUDUSD, or GBPUSD, or even EURUSD.

But once the market condition is identified, the trader can begin to outline a potential trade by matching their approach to the market condition.

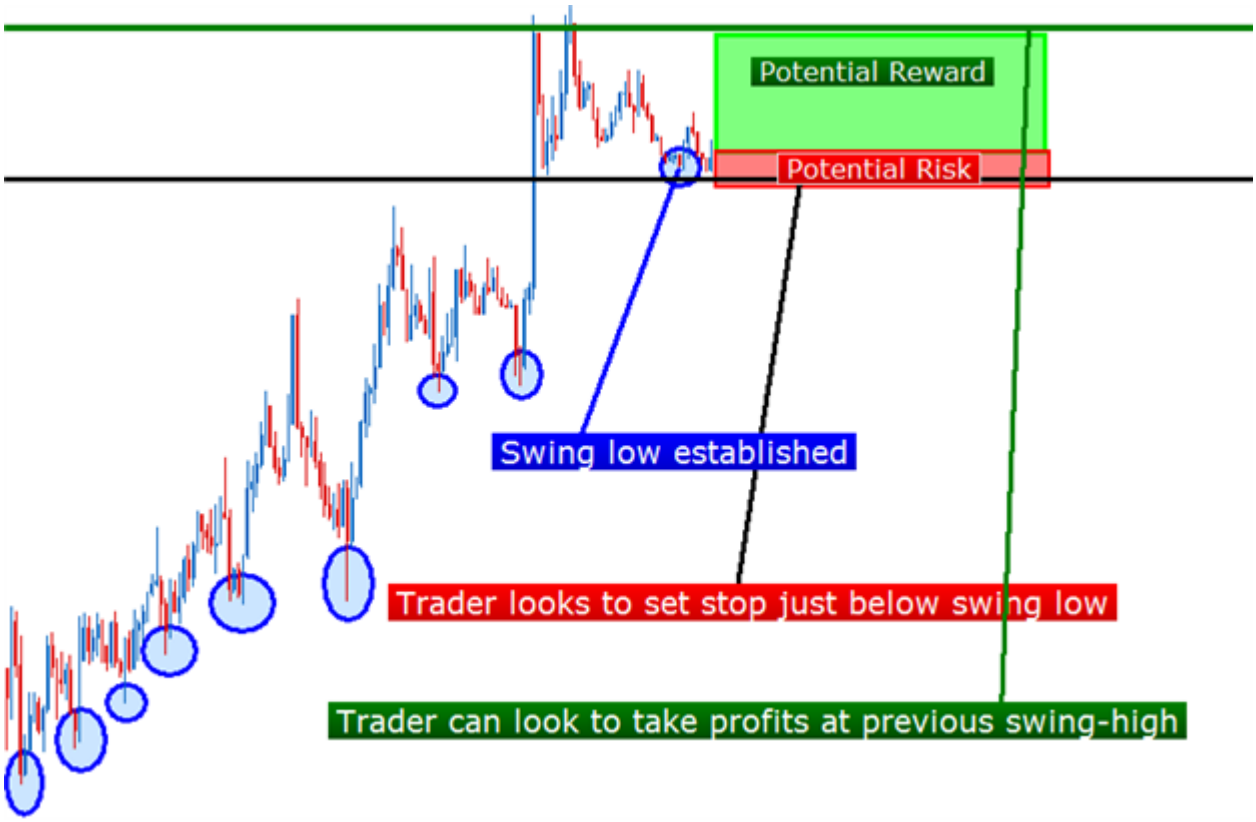
Just as we looked at in our article 'Trading Trends by Trailing Stops with Price Swings,' If the trend is up and the trader is expecting the currency pair to move higher, the goal should be to 'buy low, and sell high.' To do this, the trader wants to purchase the pair when price is close to support, or after a recent swing low has been established.

This chart will illustrate how a trader can look to setup a potential risk-to-reward ratio on a trend trade.

Swing low established
Trader looks to set stop just below swing low
Trader can look to take profits at previous swing-high

Created with Marketscope/Trading Station

After setting up the trade in this manner, we can then go a step further to calculate the potential risk-to-reward ratio on the trade:


Potential Reward
Potential Risk
Swing low established
Trader looks to set stop just below swing low
Trader can look to take profits at previous swing-high

Created with Marketscope/Trading Station

As you can see, the potential reward in this trade far outstrips the potential risk. As a matter of fact, the potential reward is approximately 5 times that of my potential risk.

So, if I were to get the same setup 10 times and place the same type of trade each time – I would only need to win on 2 of them to put myself in a position for a net profit. 2 out of 10! That is only 20%!

We can do the same type of thing for ranging markets, albeit without the luxury of a strong trend. We would want to adopt the same mantra of 'buy low – sell high,' and look to purchase when price is near support or sell when price is near resistance. The chart below will illustrate further:

Stops for SELL position go above Peak High
Look to Sell when price tests resistance
Look to buy when price tests support
Stops for BUY position goes below Peak Low

Created with Marketscope/Trading Station

In ranging markets, traders would want to look to 'buy low' when price was at or near support – planning to place a stop just on the outside of support for long positions (and just above resistance for short positions).

Once again, we only want to focus on range trades that offer a one-to-one risk to reward ratio or greater. The chart below will show the minimum accepted threshold before triggering a range trade:

Trading Trends by Trailing Stops with Price Swings

Traders are often governed within the competing emotions of greed and fear, struggling to find the right balance to get the results that they want. Nowhere is this struggle more apparent than when it comes to the topic of managing profitable trades.

What if price reverses – wiping away all of our profit before running directly to our stop?

Or perhaps we decide to just close the position – take our profit off the table. Well, what if price would have continued to go up? We just missed out on all of those pips and instead we are looking at this measly profit merely because we were scared of losing it.

This article will examine a mechanism by which traders can strike a happy medium during strong trends; and move forward confidently without every worrying about the 'what-ifs' of trade management.

Identifying Support and Resistance with Swing-High and Low's

In Price Action Swings, we looked at a way in which traders can identify support and resistance based on the study of **price action.**

During up-trends, price will often make a series of 'higher-high's' and 'higher-lows.' The picture below will illustrate:

(Created with Trading Station 2.0/Marketscope)

During downtrends, price will often make a series of 'lower-high's' and 'lower-lows.' You can see these swings identified below:

(Created with Trading Station 2.0/Marketscope)

And of course, when the market is ranging – price will often stay within Support and Resistance levels that can, once again, be identified by price action. The following picture shows some of the swing-highs and swing-lows identified during a ranging market:

Match Trade Management to the Trading Strategy

Since price action takes on different roles depending on whether the market is trending or ranging, it often behooves the trader to attempt to match their risk management to the market environment.

This article is specifically addressing trends, as they offer a comfortable mechanism of risk management to price action traders.

When a trader is looking to take part in an up-trend, they want to see higher prices to take their trade into profitability.

If price happens to reverse after the trade was entered, establishing a new short-term low, the trader may want to stop out of the position (as the pair may continue making new lows while you are holding a long position.) The graphic below will illustrate with more detail.

When Price breaks low, trader closes out of position
As position moves in favor, trader adjust stops below each swing low
Initial Stop Placed Below Price Action

(Created with Trading Station 2.0/Marketscope)

In the above chart, each swing low is identified with a small black line – and these are the areas that traders holding long positions can look to adjust stops to.

As long as this strong up-trend stays intact, the pair continues to make higher-highs and higher-lows, and this allows the trend trader a mechanism of risk management.

The red text highlights when price had gone on to establish a new low; and as you can see that allowed the trader to close their position before the pair went on to face considerable congestion.

This same type of mechanism can be done with downtrends. The chart below will illustrate further.

Initial Stop Placed
As position moves further lower, trader moves stop lower
When trend reverses (and new highs are made)
Trader is stopped out

(Created with Trading Station 2.0/Marketscope)

During down-trends, as lower-lows and lower-highs are established, this gives the trader the opportunity to adjust risk to a price slightly above the swing-highs that are established.

When the recent swing high is pierced (as you can see towards the right side of the above chart), establishing a new intermediate-term-high, the trade will automatically be closed.

A Note on Opportunity Cost

The most difficult part about teaching (or learning) trade management is the idea of opportunity cost: The concept that we may close the trade at a loss and then price might turn around and actually move in our direction.

This causes many new traders to keep many positions open far longer than they probably should. As a matter of fact, this was one of the chief findings in The Number One Mistake that Forex Traders Make; traders will often take far bigger losses when they are wrong than what they will gain when they are right.

Much of this comes from basic human psychology: Our desire to be 'right.' We don't want to admit that we are wrong for the simple fact that we have to admit that we weren't right.

But I want to leave you with this question:

Are you going to accomplish all of your goals, dreams, and aspirations with this one trade?

Probably not.

A wise man once told me that each trade should be but one of thousands in a professional trader's career. This game is a marathon, not a race.

And if you are trading in an up-trend, and price makes a new low – do you really want to stick around 'hoping' that price might turn around and give you what you want? Or would you rather absorb a small loss in a position in which you've already been proven wrong, so that you can look for greener pastures elsewhere?

Trading in strong trends and trailing stops with swing lows can help traders absorb small losses at the point at which they are proven wrong; with the potential of being able to maximize up-side gains when they are right.